

C E N T R A L I N T E L L I G E N C E A G E N C Y
O F F I C E O F N A T I O N A L E S T I M A T E S

20 August 1957

STAFF MEMORANDUM NO. 41-57

SUBJECT: Impending Economic Crisis in India*

1. The possibility that India would fall substantially short of the goals of its Second Five Year Plan (1956-61) was considered in NIE 51-56 ("India Over the Next Five Years"), dated 8 May 1956. So were the grave economic and political consequences of such a failure. These developments, however, were discussed only as hypothetical alternatives and no attempt was made to assess the relative chances for success or failure of the Plan.

2. Developments in India during the past year now appear to us to indicate that failure to achieve the key objectives of the Plan is a probability and that, in the absence of additional large scale foreign aid, development of an economic crisis sufficiently acute to shake present political stability is fairly likely.

3. The first year (April 1956-March 1957) of the Second Five Year Plan has thrown into sharp relief the principal elements in the develop-

* This memorandum has been discussed with OCI.

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ing economic crisis. These are: (a) a sharp rise in food consumption, requiring large unanticipated food imports, (b) inflationary problems within India resulting from rising incomes and deficit spending, (c) the continuing rapid and unexpected decline in foreign exchange reserves, and (d) failure to date to obtain additional foreign aid to close a gap of about \$1 billion between import requirements of the Plan and foreign exchange estimated to be available during the Plan period. The magnitude and consequences of the economic and political strains which are developing as a result of the attempt to step up the pace of development appear to have been underestimated both by the Indian Government and by many Western observers.

Internal Problems

4. Food grain prices in India rose by over 30 percent in 1956 and the cost of living by about 11 percent. The hope that the country would be self-sufficient in food at the end of the First Five Year Plan has been proven unfounded, and the government has had to raise food grain production goals during the Second Plan to 26 percent as against the original target of 15 percent. Whether or not it will be able--even with favorable weather conditions--to achieve these goals while maintaining the intensive pace of industrialization is doubtful. The government has

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also had to seek sources of additional food imports unanticipated in the Second Plan. The population increase of 5 million a year and a rising rate of food consumption make it certain that any significant shortfall in food requirements would be quickly reflected in further pressure on prices and foreign exchange reserves.

5. The inflationary trend is likely to increase in the next few years. The scale of deficit financing, already large, is to be substantially increased, i.e. from \$435 million in 1956-57 to \$578 million in 1957-58. The government has probably already gone as far as it can, short of adopting coercive measures, to reduce consumer demand through a heavier level of taxation on wealth, income, private expenditures and government services than originally thought advisable. Coercive measures, such as enforced grain deliveries or greatly increased corporation taxes, which the government may eventually feel forced to adopt, would be self-defeating under present plans since a substantial part of the programmed economic growth depends on the maintenance of incentive in the private sectors of the economy.

The Foreign Exchange Problem

6. Closely related to the internal problems is India's increasingly acute foreign exchange position. Under the pressure of heavy imports of capital equipment at rising prices and continued large food imports,

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foreign exchange reserves fell by \$722 million, from \$1.566 billion on 1 April 1956 to \$844 million by 2 August 1957. They would have been even lower were it not for a \$200 million drawing from the International Monetary Fund. The alarming aspect of this situation is that in the first year of the Plan, India exceeded the drawdown on foreign exchange reserves which had been programmed for the entire five year period, i.e. \$420 million. Further foreign exchange commitments already undertaken are estimated at between \$220 and \$360 million.

7. The sharp fall-off in foreign exchange, in addition to curtailing India's flexibility in purchasing imports needed to support the Plan, has grave internal financial implications. \$840 million of the foreign exchange reserve is allocated by law as a currency reserve. The government has recently had to breach this requirement under a provision of the law permitting a temporary reduction of foreign exchange reserves backing for the currency to \$630 million in an emergency. Unless the Plan requirements are modified or new large scale foreign aid is obtained, the \$630 million minimum statutory level will probably also have to be breached by the end of this year. Such action would probably leave India with an inadequate working balance to cover seasonal fluctuations in trade and could destroy business confidence both at home and abroad.

8. The government has given higher priority to development projects which "earn or save foreign exchange" and has imposed stringent cuts

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in import quotas. These measures are unlikely to be effective since the prospects for increased exports over the next few years appear generally unfavorable and the foreign exchange drain stems primarily from import of capital equipment required for the development program rather than from consumer items. At the same time, the government faces greater demands for foreign exchange for military purchases to support the armed forces expansion program to which it is committed in order to counter Pakistan's military development.

The Need for Foreign Aid

9. Under these circumstances, it is evident that implementation of the essential core of the Plan hangs on India's ability to obtain substantial additional foreign aid. Total cost of the Plan is estimated at \$16.8 billion. Of this, at least \$2.3 billion in foreign exchange must come from outside sources. Projecting present levels of foreign aid through March 1961, a gap of about \$1 billion still exists.* India's chances of filling this gap do not appear to be good. Several recent explorations of public and private credit sources in Europe and the US have been unsuccessful. The USSR has already given India about \$250 million in two long term loans. The second of these loans, however, cannot be drawn on until 1959.

* In calculating this gap, India's anticipated export earnings during the Plan period have already been taken into account.

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The Crisis

10. All of these factors add up--in the absence of new large scale foreign aid--to the probability of a deepening economic crisis in India during the next few years. The Indian government faces the dilemma of abandoning substantial parts of a development program which it considers minimal to the maintenance of social and political stability or of adopting increasingly severe coercive measures in an attempt to attain its economic goals under forced draft, thereby risking the very social stability it is seeking to foster. The Indians fear that prolongation of the Plan would leave India in little better economic condition than it is presently and that it would at the same time destroy public willingness to accept present austerity as a necessary prelude to future improvement.

11. Under these circumstances, the government will probably continue most reluctant to abandon its economic goals and is likely to continue with the main lines of the program, even to the extent of jeopardizing the maneuverability of the economy in terms of foreign exchange reserves and inflationary pressures. Underlying this is the strong belief in informed Indian circles that if the present economic momentum is halted, India will not soon again achieve the unity of purpose and leadership required to achieve its goals.

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The Political Consequences

12. Popular reaction to the economic situation has already been manifested and is likely to become increasingly bitter as the impact of the government's financial difficulties is felt in daily life. The urban workers and middle class, the most politically conscious groups in India, are already seeing much of their modest gains from the First Five Year Plan wiped out to support a Second Plan, which seems increasingly unlikely to be able to fulfil the promises for future betterment which have been made to them. Growing inflation will almost certainly fan the resentment of the lower classes against those who are better off as well as against the government, and the government's influence with the labor movement--which has already threatened widespread strikes--is likely to diminish.

13. The psychological implications of such a situation are difficult to assess. Speculation in both commodities and foreign exchange by certain elements in the business class are probable as the economic crisis deepens. A near-panic situation which could be manifested in wholesale smuggling, the flight of domestic capital, and the drying up of foreign investment is conceivable. A bad crop year--which India's past history indicates is not unlikely within the Plan period--would throw the economy into chaos.

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14. Even excluding the possibility of a panic situation, the political consequences to the present government of being forced to abandon its economic goals would be grave. A popular reaction against Nehru and the Congress Party, who have frequently and unequivocally equated the Plan's success with their own future would be almost certain. The result of this would be reflected in the 1962 elections and, perhaps earlier, in civil unrest which would intensify India's basic problems of disunity, such as linguistic and caste conflicts. The most likely beneficiaries of Congress' loss of power would be the Communists, whose chances of expanding the beachhead they already have in Kerala state would be greatly improved.

15. In psychological terms, perhaps the most important result of failure of the Plan would be that it would appear to prove that Communist China had won the race for economic development with India and that its authoritarian economic philosophy had produced more effective economic development than India's democratic system. Indian Communists and extreme leftist political parties would find more popular support for their totalitarian economic doctrines. Other countries of Free Asia, which have a far poorer economic base than India to begin with, might well conclude that the only workable path for economic development is that taken by the USSR and Communist China.

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Conclusions and Recommendations

16. It is clear that India is facing a progressively more serious economic crisis in its attempts to implement the Second Five Year Plan. This crisis and the probable necessity of slowing down the pace of development may be expected to have serious political consequences. Since Indian officials have made it clear they see the US as the only real hope for solution to their problem, requests for large scale new aid will almost certainly be forthcoming shortly--most likely when Finance Minister Krishnamachari visits Washington in late September.

17. US policy makers are aware of the general nature and magnitude of India's economic problems. A report by an interdepartmental study group entitled "The Economic Problem of India", dated 3 May, was submitted to Governor Adams by Mr. Clarence Randall, Chairman of the Council on Foreign Economic Policy. OIR of the Department of State has more recently published an Intelligence Report prepared in connection with the interdepartmental paper (IR 7359, 12 July 1957). While both reports cover the current economic situation in detail and provide background for consideration of the expected Indian request for aid, neither attempts to forecast future developments in the financial crisis or to estimate its political consequences.

18. We believe that such an estimate would be of value to US policy makers and suggest consideration by the Board of National Estimates of

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the following courses of action:

- (a) an approach to the Planning Board to determine whether there is an immediate requirement for an estimate of the probable courses of development of the Indian economic crisis and its political effects,
- (b) in the absence of an immediate requirement, preparation of such an estimate early in 1958 under the regular program as an essential updating of NIL 51-56 ("India Over the Next Five Years").

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